FOR ARGUMENT

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IN THE

Supreme Court of the United States

October Term, 1979

No. 78-1202

VINCENT F. CHIARELLA,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

POINT I

The government's new theories of nondisclosure liability under Rule 10b-5 for an "outsider" such as Chiarella are baseless in law.

The government agrees that silence in connection with the purchase and sale of securities amounts to a Rule 10b-5 fraud only when the silence is in breach of an affirmative duty to speak. Yet at each point in this litigation—the

district court, the circuit and now in this Court—when called upon to sustain its position by a rational exposition of the law, the government has adopted a new theory and at the same time disavowed its prior reasoning. And, the district court's reasoning was rejected by the circuit court and the circuit's opinion, in effect, discarded by the Solicitor General here.

The theory of prosecution in the district court was that Chiarella was under the same duty as a classic "insider" to disclose material, nonpublic information to selling stockholders (Pet. App. B2). The law is clear, however, that such a duty to disclose arises only when the information originates or emanates from the issuer corporation (Pet. Br. 20-31). That nexus between the information and the issuer corporations is absent in this case and the government no longer argues to the contrary.

The theory used by the Second Circuit panel majority to affirm the conviction was that Chiarella, a "market insider" who "regularly receives material nonpublic information" (Pet. App. A7-A9), was, by virtue of his status, under a duty to disclose material, nonpublic information to selling shareholders. That theory, in conflict with this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 152-153 (1972), numerous positions taken by the SEC and the recognized legality of common activities of many professional traders who have "regular access to market information" (Pet. Br. 31-36), has effectively been abandoned by the government in this Court (Res. Br. 70, n.48).

The government in this Court advances two new theories it now claims give rise to Rule 10b-5 nondisclosure liability in the circumstances of this case:

> A. Chiarella breached a duty of loyalty owed to the offeror corporations by utilizing their information for personal profit without prior disclosure to the tender offeror of his intent to do so; his nondisclosure to the offeror was a fraud; and that fraud was somehow carried over to his purchase of securities from target shareholders (Res. Br. 28-38); and
>
> B. Chiarella's failure to disclose his information to the target shareholders breached a duty he owed them arising from the fact that his information was tortiously acquired and not accessible to the target shareholders (Res. Br. 38-72).

These newly advanced theories of liability, like the old ones, misconstrue the law.[1]

A. Chiarella's breach of a duty of loyalty he owed to the offeror corporations cannot form the basis of a Rule 10b-5 violation in connection with his purchases of stock from target shareholders.

The government's theory of liability based on Chiarella's breach of a duty of loyalty he owed the offerors conflicts with the law of agency, the law of torts and the securities laws.

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1. The government also argues that Rule 10b-5 plainly covers "all" frauds by "any" person and thus Chiarella's conduct is plainly embraced by the law (Res. Br. 25-28). The argument, in a classic bootstrap analysis, begs the issue in this case which is whether Chiarella's conduct amounts to a fraud within the meaning of Section 10(b) and Rule 10b-5.

1. *Anticipatory disclosure by an agent to his principal regarding an impending breach of duty is not required by agency law.*

We do not dispute the proposition that Chiarella violated his duty as an agent of the offeror corporations not to use their confidential information for personal profit. *See* Restatement, Second, Agency §395 (1958). But contrary to the government's assertion (Res. Br. 35), there is nothing in agency law requiring an agent contemplating such a breach of loyalty to disclose the impending breach to his principal.[2] Moreover, the disclosure suggested by the government, disclosure to the offeror corporations, aside from being a footless gesture, would not have provided any information to the target shareholders who sold Chiarella their shares.

2. *An agent's failure to disclose to his principal amounts to deceit only in the context of a transaction between agent and principal.*

Assuming, *arguendo,* that Chiarella breached some disclosure duty he owed to the offerors, nondisclosure in the context of an agency relationship amounts to deceit[3] only in the context of some transaction between principal and agent. As the Restatement, Second, Torts §551(2)(a)

2. If the agent seeks his principal's consent for a breach of the duty of loyalty, then, of course, the agent is duty bound to disclose all facts which might influence the principal's judgment in consenting. *See* Restatement, Second, Agency §390.

3. To label Chiarella's conduct toward the offerors a "fraud" is at best a dubious proposition. Not all conflicts of interest, not even those involving self-dealing by a fiduciary, amount to a fraud. *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 478 (1977). Chiarella's breach of duty to the offerors was unaccompanied by any misrepresentation or failure to discharge an obligation to disclose.

makes clear in defining when nondisclosure in the context of an agency relationship amounts to a fraud:

> "*(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,*
>
> (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them" (emphasis supplied).

Chiarella's "business transaction" was not with the offeror corporations and thus his failure to disclose his impending breach of duty to them was no fraud.[4] Although a fiduciary type relationship arguably can be said to have existed between Chiarella and the offeror corporations, there was no transaction between them. The transactions at issue in this case were between Chiarella and the target shareholders between whom there was no fiduciary relationship. There is and can be no authority for the government argument that the fiduciary responsibilities flowing from the relationship between Chiarella and the offerors may be imported into the transaction between Chiarella and the target shareholders.

3. *Chiarella's breach of duty owed to the offeror corporations was not "in connection with" any securities transaction.*

Even if Chiarella's failure to disclose to the offeror corporations his impending breach of duty owed them

4. Compare, *Sim* v. *Edenborn,* 242 U.S. 131 (1919); *Strong* v. *Repide,* 213 U.S. 419, 428-433 (1909); *United States* v. *Carter,* 217 U.S. 286, 305-310 (1910); *Wardell* v. *Railroad Company,* 103 U.S. 651, 654-659 (1880) (all cited by the government [Res. Br. 36, n.19]) where fraud findings were premised on nondisclosure in the context of a transaction between parties subject to the obligations of a fiduciary relationship.

could be considered a "fraud," *that fraud* was not "in connection with" Chiarella's stock transactions as required by §10(b) and Rule 10b-5. A fraud is "in connection with" a securities transaction under Rule 10b-5 only where the defrauded party is also the purchaser or seller of securities. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952).[5] As the *Birnbaum* court wrote in presaging the rule of *Blue Chip Stamps*:

> ". . . [Rule 10b-5 is] aimed only at 'a fraud perpetrated upon the purchaser or seller' of securities and [has] no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers." (*Id.*)

Here, the offeror corporations were neither buyers nor sellers of securities in any transaction with Chiarella. Any claim of "nondisclosure" the offerors might have against Chiarella is "in connection with" their utilization of Chiarella to do confidential printing work; his nondisclosure to the offerors has no nexus at all to the decision of the target shareholders to sell their stock. *Affiliated Ute Citizens* v. *United States, supra*, 406 U.S. at 153-154; *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); *O'Brien* v. *Continental Illinois National Bank*, 431 F. Supp. 292, 296 (N.D.Ill. 1977).

5. The government cites *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), for the proposition that as long as a fraud "touches" a securities transaction the "in connection with" requirement is satisfied (Res. Br. 37). But *Bankers Life* does not detract from the purchaser-seller requirement of *Blue Chip Stamps*; in *Bankers Life* the defrauded party was the seller of securities.

B. Neither Chiarella's mere possession and use of material nonpublic information nor his means of acquiring it gives rise to a duty to disclose to target shareholders.

The government maintains that Chiarella's use of information which was "not 'equally accessible'" to the target shareholders gives rise to a duty to disclose to those shareholders (Res. Br. 40). A pure and simple failure of a buyer to disclose facts inaccessible to a seller is and always has been a most unlikely basis for liability under the common law.[6] *See* Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 Neb. L. Rev. 866, 871-76 (1979); Goldfarb, W. B., *Fraud and Nondisclosure in the Vendor-Purchaser Relation*, 8 W. Res. L. Rev. 5, 26-31 (1956). What is certain though is that open market trading on the basis and without disclosure of nonpublic information is not a Rule 10b-5 fraud.[7] *See, e.g., General Time Corp.* v. *Talley Industries,*

6. The common law cases on this issue are hardly uniform in their holdings or rationales. *Compare Laidlaw* v. *Organ*, 15 U.S. (2 Wheat.) 177, 195 (1817) *with Fox* v. *Mackreth*, 2 Cox, Ch. 320, 30 Eng. Rep. 148 (1788). Significantly, the Restatement, Second, Torts §551 does not include inaccessibility of information to one party in a transaction as a circumstance requiring disclosure.

Moreover, the scope of Rule 10b-5 law is not coterminous with the common law evolution of the tort of deceit. *See, e.g., Blue Chip Stamps* v. *Manor Drug Stores, supra*, 421 U.S. at 744.

7. Indeed, the government acknowledges as much in agreeing with the position of the *amicus* "that Section 10(b) and Rule 10b-5 would not ordinarily prohibit market professionals from carrying on their securities business while in possession of confidential information . . ." (Res. Br. 70, n.48). The government's attempt to distinguish Chiarella from "market professionals" and tender offerors on the basis of their "legitimate interests" and "essential role in the market" (Res. Br. 63-71) flies in the face of *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), where a lack of legitimate economic motive was ruled out as a basis for Rule 10b-5 liability.

The panel majority of the Second Circuit also agreed that utilization of inaccessible information was not the *sine qua non* for Rule 10b-5 fraud (*United States* v. *Chiarella*, Pet. App. A10).

Inc., 403 F. 2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). It is not "unequal access" which gives rise to a disclosure obligation in 10b-5 cases, but rather the breach of a disclosure obligation stemming from some fiduciary relationship between the trader or the original source of information and the selling shareholder. *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907, 911-912 (1961); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); *cf.* Restatement, Second, Torts §551(2)(a). When that relationship does not exist, as in the case at bar, trading without disclosure of inaccessible information is no violaton of Rule 10b-5 (Pet. Br. 25-29).

The government finally claims that it is Chiarella's "tortious acquisition" of the inaccessible information from the offerors which imposes upon him a duty to disclose that information to target shareholders (Res. Br. 41-42, 63-72). The government advances this theory in mistaken reliance on the wholly distinguishable English case of *Phillips* v. *Homfray*, L.R. 6 Ch. 770, 779-780 (1871). Pivotal in that case was the fact that the buyer obtained his undisclosed information by tortiously acquiring the information from *the seller*. Contrariwise, the target shareholders in the instant case cannot be heard to say that the claimed tortious conduct by Chiarella was inflicted on them. Moreover, it was not Chiarella's "acquisition" of the information which was wrongful—he necessarily obtained it legitimately in the course of his employment. Chiarella's "wrongful" conduct was using the information which amounts to a conversion against the offerors, *not* the selling target shareholders. There is nothing in the common

law to support the proposition that a conversion committed against one party gives rise to a disclosure obligation to an unrelated third party. From the point of view of the selling target shareholders, the result is the same whether the buyer commits a conversion against the offeror in using the information or is a consensual tippee like an institutional trader who engages in "warehousing." The point is that in neither case is there any fiduciary relationship with the selling shareholders giving rise to a duty to disclose.

In any event, it may modestly be said that Rule 10b-5 and the case law development of it does not unambiguously and with clarity impose an obligation to disclose on a trader who in utilizing nonpublic information commits a conversion on a third party not the seller, has no relationship whatever with the seller, and whose information does not emanate from the issuer. Since "ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity" (*Rewis* v. *United States*, 401 U.S. 808, 812 [1971]), theories of liability which are ambiguous at best cannot justify an interpretation of Rule 10b-5 to affirm Chiarella's conviction.

POINT II

Chiarella's conduct cannot, consistent with due process, form the basis of a criminal conviction where none of the proffered theories of liability was charged to the jury and such theories are an unpredictable departure from settled law.

As submitted in petitioner's brief in chief, this prosecution violated his right to fair notice (Pet. Br. Point II).

Similarly, the two new theories of liability advanced for the first time by the government in this Court—even if held by the Court in deciding this case to be correct, and we submit that they are not (Point I, *ante*)—simply find no basis in prior Rule 10b-5 law. As with the Second Circuit's "market insider" theory of liability, the government's latest theories may not be applied here to affirm Chiarella's conviction. *Bouie* v. *City of Columbia,* 378 U.S. 347, 352-354 (1964).

Moreover, the jury that convicted Chiarella was never charged that it must find facts now essential to the government's newly advanced theories of liability: there was no charge about a failure to disclose to the offeror corporations (the non-disclosure charge given had to do with the selling shareholders [R.884]); nor was there a charge requiring a finding that Chiarella tortiously acquired his information. "As a result, the Government's proposed interpretation of [Rule 10b-5] cannot be employed to uphold these convictions." *Rewis* v. *United States,* 401 U.S. 808, 814 (1971).

That Chiarella's conduct was not "clearly and unambiguously" prohibited by §10(b) and Rule 10b-5 is perhaps best evidenced by the numerous conflicting and novel theories advanced by the government throughout this litigation in seeking and attempting to uphold the conviction, the disagreements expressed by the four judges who have reviewed this case and the lengthy list of law review articles and other published comment about it.[8] It defies rudimentary fairness to suggest as the government does here that §10(b) and Rule 10b-5 "provide the clearest possible warning" (Res. Br. 73) that Chiarella's conduct was within their embrace when at the same time the government disavows the Second Circuit's theory of liability and offers for the first time ever two new theories of Rule 10b-5 liability.

POINT III

The trial court erred in failing to charge specific intent to defraud or deceive as an essential element of a Rule 10b-5 violation.

The government argues that *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), does not require specific intent to deceive, manipulate or defraud as the requisite mental element of a Rule 10b-5 violation and that a jury charge requiring a finding that the defendant acted willfully and knowingly "fully comports with the requirements of *Hoch-*

8. Note, *Securities Regulation, United States* v. *Chiarella,* 13 Ga. L. Rev. 636 (1979); Comment, *The Application of Rule 10b-5 to "Market Insiders": United States* v. *Chiarella,* 92 Harv. L. Rev. 1538 (1979); Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders,* 58 Neb. L. Rev. 866 (1979); Brodsky, E., "Trading on Non-Public Market Information," N.Y.L.J., Sept. 19, 20, 1979.

felder" (Res. Br. 82-86). The essence of the government position is that the Court did not mean what it said in *Hochfelder*. But there can be no question that the holding of *Hochfelder* is that in a civil action for damages under Rule 10b-5 the plaintiff must plead and prove "specific intent to deceive, manipulate or defraud."[9]

Mr. Justice Powell could not have been clearer when he wrote (*id.* at 193):

> "We granted certiorari to resolve whether a private cause of action for damages will lie under §10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' —intent to deceive, manipulate, or defraud. 421 U.S. 909, 95 S. Ct. 1557, 431 L. Ed. 2d 773 (1975). We conclude that it will not and therefore we reverse."

The holding in *Hochfelder* was based on this Court's view that the language of §10(b) "connotes intentional or willful conduct *designed to deceive or defraud investors* . . ." (*id.* at 199). (Emphasis supplied.)

Such specific intent is much different from the general criminal intent required by §32(a) ("knowingly and willfully") which was charged (Pet. Br. 50-51).

The government also takes issue with petitioner's request to charge defining the element of specific intent to defraud (Res. Br. 86-88). Such an argument is at best disingenuous. To be sure, Chiarella did request an instruction which sought to amplify the concept of "intent

9. The government misses the point in turning to law dictionaries for definitions of "scienter" (Res. Br. 82, n.61). Although the term "scienter" embraces many mental states as a general proposition, the brand of "scienter" required by *Hochfelder* is specific "intent to deceive, manipulate or defraud."

to defraud." But entirely separate and apart from that request, Chiarella also specifically requested an "intent to defraud" instruction *simpliciter*. Thus, Chiarella specifically requested the trial court to instruct that the jury acquit unless it found beyond a reasonable doubt that Chiarella acted "with the intent to defraud or deceive." (Petitioner's Request No. 14).

POINT IV

The government's restrictive reading of the confidentiality provisions of the New York Labor Law and the policies upon which it is based is in direct conflict with the plain language of the statute and the decisional law enforcing it.

As the government correctly points out, the unambiguous language employed in Section 537(1) of the New York Labor Law is the focal point of our argument in Point IV of our brief. And yet, in its effort to refute our initial premise, the government asks this Court to ignore the clear language it has carefully highlighted for the Court's attention.

While the government apparently concedes that Chiarella's statement falls within the statutory privilege, the government makes much of the fact that the statute does contain exceptions to the prohibition on (a) disclosure of the information by the Commissioner of Labor and (b) of its admission in the state courts (Res. Br. 89). Not once, however, does the government suggest how those exceptions apply to the instant case. The plain fact is that not one of the exceptions set out and italicized in the govern-

ment's brief has even the remotest application to the facts at hand.

First, the statute unmistakably bars the Commissioner of Labor, who administers the State Unemployment Insurance program, from disclosing information supplied by an employee, like Chiarella, who seeks benefits under the program. Section 537(1) provides but one narrow exception to this disclosure prohibition: the Commissioner may reveal the required information if it is material to the determination of the claim for benefits and, in those cases, such disclosure is limited to the "parties affected" by the claim or to the parties affected "in connection with effecting placement."

Surely, this language may not be read to contain legislative authorization for the Commissioner to release the information supplied by Chiarella to the Federal Bureau of Investigation, an agency unaffected by the "claim for benefits" or "in effecting placement." Accordingly, when, as claimed here, the Commissioner did approve the release of the privileged information to the FBI, he was acting in clear violation of the statute.[10]

Second, and of paramount importance, it is quite clear that regardless of whether the Commissioner's approved *disclosure* of the information was authorized, the fact

10. Indeed, the only significance of the Commissioner's alleged approval for the release of the petitioner's statement is that, under subsection 2 of Section 537, that approval provided a valid defense to any criminal prosecution for those persons who actually disclosed the information. Although the Commissioner's approval of the disclosure in this case may bar a criminal charge, it in no way legitimizes the Commissioner's action, which, as we have shown, was unauthorized in the first instance.

remains that the information disclosed would not be *admissible* in the courts of New York State. In express terms the legislature provided that the information provided by an employee "shall not . . . be used in any court in any action or proceeding pending therein." The legislature carefully delineated one exception to the rule, that is, where the "commissioner is a party to such action or proceeding." As with the other exceptions employed by the legislature, this one is totally inapplicable to the instant case. Not surprisingly, the state cases which have considered these confidentiality provisions and the exceptions (Pet. Br. 55-56), have uniformly barred admission of such statements as required by the explicit legislative mandate. Nor does the government even attempt to distinguish or in any way undermine these cases.

In sum, New York law prohibited both disclosure and subsequent admission of Chiarella's statement to the Department of Labor. Under these circumstances, to suggest, as the government does, that the use of Chiarella's statement at trial will not violate the state law and frustrate the policies underlying it is quite simply absurd (Res. Br. 90). This strong and clearly expressed legislative resolve to protect the confidentiality of Chiarella's statement should be honored in the federal courts. The federal interests which support federal recognition of the privilege are fully set forth in our main brief and need not be repeated here.

Conclusion

For the above reasons and the reasons presented in petitioner's brief in chief, the judgment of the Court of Appeals for the Second Circuit should be reversed with instructions to dismiss the indictment.

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Respectfully submitted,

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